

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
BRATTAIN CONTRACTORS, INC.)

Appearances:

For Appellant: E. H. Williams
Certified Public Accountant

For Respondent: Richard A. Watson
Counsel,

O P I N I O N

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Brattain Contractors, Inc., against a proposed assessment of additional franchise tax in the amount of \$3,575 for the income year ended December 31, 1963.

The question presented is whether a \$65,000 debt owed to appellant became either wholly or partially worthless during 1963.

Appellant, a general building contractor, was incorporated in California on January 15, 1960. Edwin E. Brattain has at all relevant times been its president and sole shareholder. Binary Electronics Company (hereinafter referred to as Binary), an electronics manufacturer, was incorporated in California on February 19, 1960. Until 1964 all of Binary's 210 outstanding shares were owned by its officers: Robert A. Bailey, President, 112 shares; Otto F. Vogel, Vice-President, 28 shares; and Edwin E. Brattain, Secretary-Treasurer, 70 shares.

The \$65,000 debt resulted from a series of loans that appellant made to Binary between January 3, 1961, and

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September 12, 1962. Binary executed a promissory note for the amount of each loan. None of these notes could be located at the time of respondent's audit or subsequently, but apparently repayments were not to begin until July 1, 1965, and Binary paid no interest to appellant. Portions of the loans were guaranteed by Bailey and Vogel. Vogel, who owned about 13 percent of Binary's stock, limited his guaranty to the lesser of \$10,000 or one-sixth of the loans. Bailey's written guaranty could not be found, but the parties appear to agree that his guaranty was analogous to Vogel's. That is, since he owned about 53 percent of Binary's stock, his guaranty was limited to the lesser of \$30,000 or one-half of the loans. Apparently both guarantors waived the benefits of bankruptcy exemptions and the right to demand reimbursement from Binary, if forced to pay its debt.

Binary began experiencing financial trouble in mid-1963. Sometime in the fall of that year, one Howard Finn contacted Robert Bailey to determine whether Binary might be worth acquiring. According to Bailey's recollection, the outlook for Binary at this time was very bleak: all production had been halted, a tax lien had been filed, Binary's bank account had been attached, its landlord was trying to oust it from its business premises; only a skeleton work force had been retained, and Binary was able to meet its payroll only after receiving a substantial personal loan from Bailey. Binary's unaudited **-financial statements for 1963** confirm these indications of deep trouble. During that year Binary's cumulative deficit increased from \$23,288 to \$180,174. Moreover, while its sales increased substantially during the last seven months of the year, its losses increased at an even higher rate.

In spite of Binary's apparent difficulties, Finn decided early in 1964 to buy the company, if its creditors would agree to compromise its debts. A majority of Binary's creditors, including appellant, agreed to accept about fifteen cents on the dollar in full satisfaction of their claims. As part of the plan to effectuate the sale of Binary to Finn, Brattain and Finn entered into an agreement dated March 24, 1964. Under this agreement Brattain agreed to transfer his stock in Binary to Finn and to cause appellant to sell Finn, for the sum of \$9,000, its \$65,000 of notes receivable from Binary. Finn agreed to pay Binary's taxes and trade payables in the estimated amounts of \$7,000 and \$60,000, respectively. In addition, appellant was to receive, subject to a maximum of \$10,000, 50 per-cent

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of an option specified in a separate agreement between Finn and Bailey. On May 18, 1964, appellant's board of directors authorized the sale of the notes to Finn for \$9,000, and on the same day Brattain resigned as an officer of Binary.

In its franchise tax return for 1963, appellant deducted the entire \$65,000 of loans to Binary as a bad debt. Respondent determined that the debt did not become worthless until 1964, when it was sold to Finn. Accordingly, respondent disallowed the claimed bad debt deduction for 1963 and issued an assessment of additional tax. Appellant takes this appeal from respondent's denial of its protest against that assessment.

Revenue and Taxation Code section 24348 allows a deduction for "debts which become worthless within the income year." Appellant contends that the \$65,000 debt became wholly worthless during 1963 because Binary was hopelessly insolvent by the end of that year. Standing alone, however, the debtor's insolvency does not establish worthlessness, even if the insolvency persists over a number of years. At the most, insolvency means that the debt was probably uncollectible in part. (Trinco Industries, Inc., 22 T.C. 959; Miriam Coward Pierson, 27 T.C. 330, aff'd, 253 F.2d 928.) That Binary's debt to appellant was probably collectible at least in part during 1963 is evidenced by Binary's ownership^{1/} of some \$50,000 in assets as of December 31, 1963, and by the guaranties given by Bailey and Vogel in the approximate total amount of \$40,000. No evidence was offered to show either that the guarantors were unable to make good on their promises or that the guaranties were not valid and binding obligations. Consequently, there is no basis for a conclusion that the \$65,000 debt became wholly worthless during 1963.

As an alternative contention, appellant argues, that it should at least be allowed a deduction for the partial worthlessness of the debt during 1963. Appellant relies on that part of Revenue and Taxation Code section 24348 which provides :

^{1/} Appellant's representative stated subsequent to the hearing that these assets were substantially pledged against bank loans, but no evidence was offered to support this allegation.

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When satisfied that a debt is recoverable in part only the Franchise Tax Board may 'allow such debt, in an amount not in excess' of the part charged off within the income year, as a deduction;...

Construing nearly identical language appearing in section 166 of the Internal Revenue Code, the federal courts have held that a deduction for partial worthlessness is allowable only to the extent that the taxpayer is able to demonstrate to the satisfaction of the tax administrator that a part of a debt is not recoverable. (H. W. Findley, 25 T.C. 311, aff'd per curiam, 236 F.2d 959; Giles E. Bullock, 26 T.C. 276, aff'd per curiam, 253 F.2d 715.) They have also held that the use of the word "may" in this section gives the administrator a certain amount of discretion in making his determinations and that those determinations should not be disturbed unless they are plainly arbitrary or unreasonable. (H. W. Findley, supra; Giles E. Bullock, supra.)

Appellant first raised the issue of partial worthlessness before us. However, respondent has said that it would not have allowed a deduction for partial worthlessness on the basis of the record presented on appeal. After reviewing the record carefully, we cannot say that respondent would have abused its discretion by denying this deduction. Appellant contends that the debt was worthless to the extent of \$56,000 -- the difference between the total debt (\$65,000) and the amount Finn paid for the notes in 1964 (\$9,000) -- but this ignores the two guaranties amounting to \$40,000 and the approximately \$50,000 in assets owned by Binary as of December-31, 1963. It also ignores the fact that Binary's financial condition may have worsened between the end of 1963 and the time Finn agreed to buy the notes for \$9,000. Under these circumstances, a finding of partial worthlessness in the amount of \$56,000 in 1963 could not possibly be made. And in view of the many, factual uncertainties present here, we must conclude that appellant has failed to establish partial worthlessness in any other amount.

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O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED,. ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Brattain Contractors, Inc., against a proposed assessment of additional franchise tax in the amount of \$3,575 for the income year ended December 31, 1963, be and the same is hereby sustained.

Done at Sacramento,. California, this 27th day of October , 1971, by the State Board of Equalization.

[Signature], Chairman
[Signature], Member
[Signature], Member
_____, Member
_____, Member

ATTEST: *[Signature]*, Secretary